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Thomas W. Hayes
Auditor General

January 6, 1986

F-563

Honorable Art Agnos, Chairman
Members, Joint Legislative
Audit Committee
State Capitol, Room 3151
Sacramento, California 95814

Dear Mr. Chairman and Members:

This letter provides the results of our review of the Architecture Revolving Fund's (fund) projected cash flow for fiscal year 1986-87 and our review of the fund's accounting system. We conducted this review in response to a request in the Supplemental Report of the 1985 Budget Act.

It appears that the fund will have an adequate cash balance to meet its cash needs without the additional \$4.5 million appropriation the Department of General Services (department) has requested. We project an average monthly cash balance of approximately \$60 million in the fund for fiscal year 1986-87 with projected monthly cash receipts of \$6.3 million and projected monthly cash disbursements of \$5.8 million. Further, the fund's accounting system provides adequate information to meet the financial reporting requirements prescribed by the State Administrative Manual and those prescribed by generally accepted accounting principles; however, the department does not always use the information appropriately to give an accurate accounting of the fund's financial condition.

Background

The fund is the depository for cash advances received from state agencies for construction projects that are administered by the Office of the State Architect (State Architect), a division of the department. The State Architect recovers its costs through charges to project monies on deposit in the fund. The State Architect charges the projects for the actual amount of construction costs; however, the State Architect's labor fees are based on an hourly billing rate. The department, which accounts for the fund, periodically compares fees based on this billing rate to the actual expenses of the State Architect in order to determine the adequacy of the hourly billing rate.

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In fiscal year 1984-85, the department discovered errors in its accounting procedures that resulted in its overstating the amount of fees earned by the State Architect during the previous seven years. The department erroneously included some fees twice when computing the amount of fees earned by the State Architect. According to the department, because of these procedural accounting errors, the State Architect had not earned approximately \$4.5 million in fees credited to the fund's balance. The department corrected these errors in the accounting records during fiscal year 1984-85, and at June 30, 1985, the department reported a \$6.0 million deficit in the fund. To rectify the effects of the accounting errors, the department has requested appropriations totaling \$4.5 million.

To evaluate the adequacy of the fund's cash balance to meet current and future needs, we examined the cash flow projections provided by the department for fiscal years 1985-86 and 1986-87. We analyzed the assumptions underlying the cash flow projections, tested the methodology used to make the projections, examined the supporting documentation, and compared the projections with the actual cash flow information from fiscal years 1983-84 and 1984-85 to determine if the projections are reasonable. To determine the adequacy of the fund's accounting system, we examined the accuracy and completeness of the accounting records, including the financial statements, accounting ledgers, cost accounting reports, and supporting worksheets and calculations. Finally, we examined the department's analysis of the accounting error that contributed to the current fund balance deficit and determined that the department's analysis was accurate.

It was not within the scope of this review to conduct an examination in accordance with generally accepted auditing standards that would enable us to express an opinion on any of the financial information referred to in this report.

Cash Flow Projections

The fund appears to have an adequate cash balance to meet current and future cash needs without an additional appropriation. The projected average cash balance for fiscal year 1986-87 is approximately \$60 million, with average monthly cash receipts of \$6.3 million and cash disbursements of \$5.8 million. The projected average cash balance represents the cash needs for approximately ten months.

We believe that the fund has an adequate cash balance to meet current and future cash needs without an additional appropriation as long as the State Architect continues to receive funding for new projects. The

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current cash balance is not adequate to complete all existing projects since the State Architect has incurred costs that are higher than the amounts appropriated for some projects. Therefore, unless the State Architect continues to receive, in advance, monies for new projects, the cash balance will be exhausted.

Because state law and fiscal controls forbid state agencies to spend state funds for purposes not designated by the Legislature, the department should recover the fees that it failed to receive as a result of the accounting error. The department has determined that the State Architect can recover these fees through an appropriation of funds or an increase in the fees that the State Architect charges for services. The department estimates that the State Architect can recover these fees within nine to ten years by adding a surcharge to the State Architect's fees.

The attachment to this letter presents cash flow information for fiscal years 1983-84 through 1986-87. The attachment presents actual cash figures for July 1983 through September 1985 and projected cash figures for October 1985 through June 1987. The department based the projections for 1985-86 on the State Architect's tentative planning and construction schedules for projects with budget appropriations. The timing of cash receipts for each project is based on an estimate of when various phases of the project will occur. For example, the fund receives a cash advance for the cost of construction when a project goes out to bid. The department estimated cash disbursements by dividing total construction costs by the number of months allocated to the construction phase of the project. The department assumes that funding for fiscal year 1986-87 will not increase at the same rate it did in previous years; consequently, in calculating its projections, the department took an average of the prior two years' cash flow and then, using a construction price index, added 3 percent each year for inflation.

Accounting System

The fund's accounting system provides adequate information to meet the financial reporting requirements prescribed by the State Administrative Manual and those prescribed by generally accepted accounting principles. However, we noted a deficiency in the department's accounting procedures that has resulted in the department's overstating the amount of costs recovered by the State Architect. As a result, we estimate that the June 30, 1985, reported fund deficit of \$6.0 million is understated by approximately \$1.9 million.

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When the Department of Finance authorizes the State Architect to start work on a project for a state agency, the State Controller transfers monies to pay for the project from the state agency's capital outlay appropriation to the fund. If the State Architect spends more than the amount appropriated for the project, it may be unable to recover the excess costs. However, if the State Architect spends less than the project appropriation, it must return to the state agency any monies appropriated in excess of his actual costs.

As the State Architect incurs costs, the department records all of its expenses. The department records all expenses incurred by specific projects to an applied expense account, which represents those expenses that the State Architect will recover from the appropriations for the project. However, when the department records expenses to the applied expense account, it does not determine whether the individual projects have an adequate appropriation to pay for these expenses. At June 30, the department offsets the total expenses applied to all projects against the State Architect's total expenses for the fiscal year to determine the amount of increase or decrease in the fund balance.

This procedure would be appropriate if the State Architect never incurred costs in excess of the amount appropriated for a project; however, as the Office of the Auditor General reported in March 1985, the State Architect has spent more than appropriated on some projects.* Consequently, by recording all expenses related to projects as though they will be recovered, the department overstates the fund balance. The following hypothetical example illustrates this point.

Assume that there are two projects: Project A, with an appropriation of \$100,000 and costs of \$90,000, and Project B, with an appropriation of \$100,000 and costs of \$105,000. Using the department's procedures, the department would record expenses and applied expenses of \$195,000. The fund would not show a loss because total expenses equal the total applied expenses. However, the State Architect has actually incurred a \$5,000 loss since it cannot recover costs in excess of the amount appropriated for Project B. If the State Architect subsequently receives additional funding for Project B, the loss is only temporary; however, if no additional funding is received, the loss is permanent.

*This report is entitled "The Office of the State Architect Spent More Than Authorized for Some Construction Projects," Report P-476, March 1985.

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At June 30, 1985, 200 of the State Architect's projects exceeded the cash advanced for them by a total of approximately \$7.8 million. Of this amount, \$1.9 million is for projects for which the State Architect will probably not receive any additional funding. As a result, we estimate that the fund deficit is \$7.9 million at June 30, 1985.

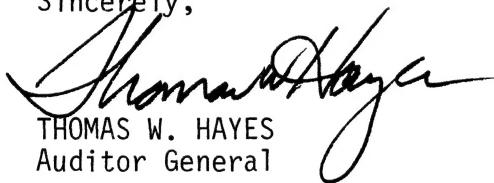
Recommendation

The department should record as applied expenses only those project costs it expects to recover within one fiscal year.

The Office of the Auditor General is auditing the Architecture Revolving Fund in conjunction with its audit of the State's financial statements. That audit was not complete by the end of our fieldwork; consequently, we have not included the results of that audit here. The Office of the Auditor General will issue a report in March 1986 that will include the findings related to its financial audit of the Architecture Revolving Fund.

We conducted this review under the authority vested in the Auditor General by Section 10500 et seq. of the California Government Code. We limited our review to those areas specified in the background section of this letter.

Sincerely,

A handwritten signature in black ink, appearing to read "Thomas W. Hayes".

THOMAS W. HAYES
Auditor General

Attachment

**ARCHITECTURE REVOLVING FUND'S ACTUAL CASH FLOW
JULY 1983 THROUGH SEPTEMBER 1985
AND PROJECTED CASH FLOW
OCTOBER 1985 THROUGH JUNE 1987
(IN THOUSANDS)**

	<u>July</u>	<u>August</u>	<u>September</u>	<u>October</u>	<u>November</u>	<u>December</u>	<u>January</u>	<u>February</u>	<u>March</u>	<u>April</u>	<u>May</u>	<u>June</u>	<u>Total</u>	<u>Average Monthly Balance</u>
1983-84														
Beginning balance	\$37,966*	\$32,768	\$32,693	\$29,348	\$29,435	\$40,149	\$24,632	\$20,134	\$35,077	\$29,764	\$33,174	\$35,029	\$380,069	
Cash receipts	2,449	3,826	3,406	3,608	17,329+	4,875	1,117	17,919+	1,643	6,316	7,869	10,242	80,599	\$ 6,716
Cash disbursements	(7,547)	(3,901)	(6,751)	(3,521)	(6,615)	(20,392) #	(5,615)	(2,976)	(6,956)	(2,906)	(6,014)	(5,237)	(78,431)	(6,536)
Ending balance	\$32,768	\$32,693	\$29,348	\$29,435	\$40,149	\$24,632	\$20,134	\$35,077	\$29,764	\$33,174	\$35,029	\$40,034	\$382,237	\$31,853
1984-85														
Beginning balance	\$40,034	\$36,617	\$40,706	\$38,892	\$43,522	\$46,760	\$44,440	\$42,746	\$48,223	\$48,143	\$46,182	\$40,218	\$516,483	
Cash receipts	2,172	7,872	2,745	7,040	5,872	4,017	1,407	8,646	8,643	2,954	1,458	6,908	59,734	\$ 4,978
Cash disbursements	(5,589)	(3,783)	(4,559)	(2,410)	(12,634)	(6,337)	(3,101)	(3,169)	(8,723)	(4,915)	(7,422)	(4,637)	(57,279)	(4,773)
Ending balance	\$36,617	\$40,706	\$38,892	\$43,522	\$46,760	\$44,440	\$42,746	\$48,223	\$48,143	\$46,182	\$42,489	\$40,218	\$518,938	\$43,245
1985-86														
Beginning balance	\$42,489	\$44,586	\$49,384	\$51,210	\$47,463	\$48,697	\$50,775	\$53,740	\$51,727	\$65,524	\$63,022	\$60,221	\$628,838	
Cash receipts	10,711	8,266	7,345	3,468	6,132	10,022	8,944	3,810	21,490	3,969	3,468	2,326	89,951	\$ 7,496
Cash disbursements	(8,614)	(3,468)	(5,519)	(7,215)	(4,898)	(7,944)	(5,979)	(5,823)	(7,693)	(6,471)	(6,269)	(8,883)	(78,776)	(6,565)
Ending balance	\$44,586	\$49,384	\$51,210	\$47,463	\$48,697	\$50,775	\$53,740	\$51,727	\$65,524	\$63,022	\$60,221	\$53,664	\$640,013	\$53,334
1986-87														
Beginning balance	\$53,664	\$53,943	\$57,451	\$59,080	\$58,094	\$60,448	\$61,565	\$60,675	\$62,546	\$70,891	\$67,003	\$63,707	\$729,067	
Cash receipts	5,202	7,430	5,241	5,524	6,276	7,296	5,355	6,553	15,561	3,613	2,561	4,865	75,577	\$ 6,298
Cash disbursements	(4,923)	(3,922)	(3,612)	(6,510)	(3,922)	(6,179)	(6,245)	(4,682)	(7,316)	(7,501)	(5,857)	(8,591)	(69,260)	(5,772)
Ending balance	\$53,943	\$57,451	\$59,080	\$58,094	\$60,448	\$61,565	\$60,675	\$62,546	\$70,891	\$67,003	\$63,707	\$59,981	\$735,384	\$61,282

*At July 1, 1983, there was an outstanding loan to the General Fund of \$15.9 million.

+These cash receipts include repayments of loans from the General Fund of \$15.9 million in November and \$14 million in February.

#These disbursements include a loan to the General Fund of \$15.9 million.

Source: We extracted the July 1983 through September 1985 figures from the Architecture Revolving Fund's general ledger.
The department prepared the projections for October 1985 through June 1987.